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Devaluations and emerging stock market returns

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Abstract

Stock returns over the 2 years surrounding 24 currency devaluations are examined. Using bootstrapped distributions, returns preceding the devaluation are shown to be significantly below normal, in both dollar and local currency terms. Most of the downturn, however, occurs well before the month of the devaluation. Returns following a devaluation are normal. While industry and company specific effects appear to influence return behavior, only country effects and leverage levels are statistically significant. At the country level, both aggregate economic activity (GDP) and the size of the devaluation are important in explaining return behavior. The stock of foreign debt has little impact on returns. Finally, even though returns appear to anticipate devaluations, they are not statistically significant at predicting the size of the devaluation.

Keywords: Stock market; Currency

1. Introduction

Large and discrete currency movements are not uncommon events in many emerging markets.[1] When and why such events occur has been hotly debated among monetary and macroeconomists for many years.[2] Exactly what impact these events have on the real and financial sectors of the underlying economies is less well studied.

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[1] IMF (2002, Box 3.3, page 113) presents an overview of emerging market crises, including both currency and banking crises, and provides ample references to the literature on these events.

[2] Dornbusch (2001) provides a non-technical overview of emerging market crises. Kamin et al. (2001) look at crises empirically to identify the factors, both internal and external, that predict when crises occur.

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Conceptually, a devaluation should both increase inflation and stimulate economic activity through exports. In addition, by relaxing the constraints imposed on the monetary authorities, interest rates can be relaxed and liquidity increased. But these results are not always the case and devaluations are often followed by high interest rates and poor economic performance.

Over the last two decades a number of emerging stock markets have developed as viable investment alternatives for international investors. While one can debate the various merits of these markets, one thing many of them have in common is exposure to the risk of a currency devaluation. For the foreign investor this risk is obvious because stocks are priced in local currency and any exchange rate change will pass through to stock returns. However, stock prices themselves reflect the value of the real assets underlying the shares and the impact of currency changes on these real assets is uncertain.[3]

This paper looks at stock market performance over a sample of 24 devaluation events covering 18 emerging market countries over the period 1980–1999. The analysis compares stock market performance before and after the devaluation event with the general distribution of returns for these markets. The paper also examines several factors that differentiate the performance of the markets.

The findings suggest that devaluations have a significant negative impact on returns, both in dollar and local currency terms, in the months preceding the event. This impact is statistically significant on average, but there is also considerable variation across events and countries. The analysis suggests that market reaction following an event is closely tied to economic recovery and a more relaxed monetary environment.

The remainder of the paper is organized as follows: Section 2 describes the country event data; Section 3 looks at the behavior of individual stocks during these events and Section 4 examines the links between country market behavior and the macroeconomy. Sections 5 and 6 examine the ability of stock markets to predict devaluation size and longer-term behavior of markets prior to currency events, respectively. Conclusions and a summary are contained in the final section.

2. Country market indices

The data used in this study consist of stock market returns for 18 countries from the Emerging Markets Database over most of the life of the database: 1980–2001. The database also includes exchange rate data and from that data 24 devaluation events were identified, where an event is defined as a significant change in value relative to the US dollar. Not all of these events involved moving from a fixed peg to a new higher fixed value. In some cases the currencies were maintained in a controlled float, often with a predetermined rate of depreciation. Also, in some cases the currency regime that followed the devaluation was one of market determination.

[3] Research on the impact of currency exposure on stock returns is well developed, but addresses a different topic than is addressed here. For the impact of hedging currency exposure in stock portfolios see Glen and Jorion (1993); for measuring currency exposure see Bodnar and Franco Wong (2000).